PREME COURT, U. S.

75-286

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IN THE

Supreme Court of the United States

October Term 1975

MARSHALL FOODS, INC.,

Petitioner,

vs.

UNITED STATES OF AMERICA

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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Marshall Foods, Inc., prays that a writ of certiorari issue under 28 United States Code §1254 to review the judgment of the Court of Appeals for the Eighth Circuit entered in this case on June 2, 1975, affirming a judgment entered by the District Court of the United States for the District of Minnesota, Second Division, dismissing on the merits the petitioner's suit, brought under 28 U.S. Code §1346(a) (1), for the recovery of internal revenue taxes alleged to have been erroneously assessed and collected.

JURISDICTION

The judgment of the Court of Appeals was entered June 2, 1975. The jurisdiction of this Court is invoked under Title 28 of the United States Code §1254 and §7482(a) of the Internal Revenue Code of 1954.

OPINIONS BELOW

The opinion of the Court of Appeals, by court direction, will not be published. However, it is reported unofficially in 75-2 U.S. Tax Cases ¶9536, It is *per curiam* and states that the Court of Appeals "affirm[s] the judgment of dismissal on the basis of the district judge's well reasoned and comprehensive opinion. See Rule 14." The Court's Rule 14 provides that when the Court determines, among other alternatives, that "no error of law appears" and further that "an opinion would have no precedential value, the judgment * * * may be affirmed without opinion." 28 U.S.C.A., Appendix, p. 183.

The opinion of the District Court has not been reported officially. It is reported unofficially in 75-1 U. S. Tax Cases ¶9121 and, together with the opinion of the Court of Appeals, is included in the Appendix.

QUESTION PRESENTED

Whether a recognized gain is taxable only as capital gain, not ordinary income, when it represents the sum of a fixed dollar amount specified in and paid under a policy of insurance by reason of each day's loss by the insured of the use and occupancy of property held for more than six months and used in its trade or business, on the ground that such gain is gain from the "compulsory or involuntary conversion (as a result of destruction * * *)" of such property into other property or money within the meaning of the foregoing quoted words contained in §1231 of the Internal Revenue Code.

STATUTE INVOLVED

U. S. Code, Title 26 (Internal Revenue Code)

It is believed that the only statutory provisions immediately determinative of the Question Presented are contained in the following portion of §1231(a):

SEC. 1231. PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS.

> (a) GENERAL RULE.—If during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months.* * *[1]

However, because it contains operative provisions which are identical in substance with those quoted from §1231 (a) in the Question Presented and have been the subject of interpretation by Courts of Appeals and other federal courts, §1033(a) (1) is also added:

SEC. 1033. INVOLUNTARY CONVERSIONS.

> (a) GENERAL RULE.—If property (as a result of its destruction in whole or in part, theft, seizure,

[1]Other statutory provisions are included in the Statutes set out in the Appendix.

or requistion or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted—

(1) CONVERSION INTO SIMILAR PROPERTY.—Into property similar or related in service or use to the property so converted, no gain shall be recognized.

SUMMARY STATEMENT

The petitioner has for many years been engaged in the business, among others, of the manufacture and sale of egg powder, for which purpose it has owned and operated in Marshall, Minnesota, an egg-drying plant, sometimes referred to as the main plant. (Stip. ¶1.) On July 8, 1965, the petitioner, acting through independent public accountants, wrote a letter to a firm of insurance agents requesting that it place in effect, with respect to the business conducted in the main plant and with respect also to other plants owned and operated by the petitioner or by related companies, Business Interruption Insurance —that for the main plant to be "for a Daily Indemnity of $5,000.00 per day [of total suspension of business] with 180 days' limitation and with $5,000 deductible." Net profit was not taken into account by the taxpayer in requesting this amount of coverage, and neither then nor at any other time were any net earnings figures supplied to the insurers or their representatives. (Tr. A, pp. 13, 14, 15; Tr. B, pp. 9-10.)[2] The requested indemnity was based on and intended to reflect the amount of funds thought necessary to meet continuing expenses during a

[2]Transcripts of the depositions of two participating accountants are referred to respectively as Tr. A and Tr. B.

suspension period. (Tr. A, p. 18.) In the case of the main plant it was the quotient of assumed annual gross earnings approximating $1,500,000 divided by 300, the estimated annual number of working days, and was supplied by letter dated August 6, 1965, in response to a request by the agents in order to enable the insurers to determine the amount of indemnity they would be willing to provide. It was given after review of main plant operations during the preceding year, which had resulted in an operating loss. (Stip. ¶3, Ex. 3-C; Tr. A, p. 13; Tr. B, pp. 28-29.)

Five days after submission of the foregoing information the accountants were informed by the agents that the requested coverage "had been placed effective August 6, 1965", subject, however, to "justification that the amount of indemnity per diem is not in excess of your exposure", in response to which the accountants on August 14, 1965, furnished with respect to the other plants information similar to that supplied with respect to the main plant on August 6, 1965. (Stip. ¶3, Ex. 2-B, Ex. 4-D.) On August 31, 1965, following receipt of this information, the agents wrote to the accountants enclosing two so-called binders or cover notes of European underwriters effecting the requested coverage for a three-year period beginning August 6, 1965, subject to the terms and conditions of the formal policies to be issued. (Stip. ¶3, Exs. 5-E, 6-F, 7-G.) Enclosed with this letter were several copies of a form of Business Interruption Work Sheet, with a request that they be completed with respect to the several plants. (Stip. ¶3, Ex. 5-E.) As to the main plant the following information was in response submitted for the fiscal year ended April 3, 1965:

A.	Total net sales from operations		$10,967,353
B.	Other operating income		115,860
C.	Total of A and B		$11,083,395
D.	1. Cost of raw stock	$9,013,122	
	2. Cost of consumed materials	681,052	
Total "deductions"			$9,694,174
E.	Gross earnings		$1,389,221

To arrive at net profit it would have been necessary to subtract from the gross earnings figure the cost of such items as labor, plant supplies, depreciation, insurance, taxes, fuel, advertising, professional fees, dues and subscriptions, executive compensation, selling expenses, and interest, none of which, except (as noted later) Ordinary Payroll expense, was ever supplied to the insurers or their representatives. (Stip. ¶3, Exs. 8-H, 9-I, 10-J.)

Noting the difference between the assumed annual gross earnings of $1,500,000 set out in the accountants' letter of August 6, 1965 (Stip. ¶3 and Ex. 3-C), and the foregoing actual gross earnings figure of $1,389,221, the agents on September 30, 1965, inquired of the accountants by letter whether an increase in gross earnings was expected, which the accountants on October 11, 1965, answered in the affirmative, adding that this was "part of the reason for using the $5,000.00 [daily indemnity] figure". (Stip. ¶3, and Exs. 11-K and 12-L.) In a postscript to their September 30 letter the agents reported that they had just been informed by the underwriters that "Ordinary Payroll can not be included in the Per Diem

Amount covered" and therefore asked for the "annual Ordinary Payroll" so as to "complete the worksheets." As to this the accountants stated in their reply of October 11 that it is "almost impossible to tell what the Ordinary Payroll figures would be" and then listed certain figures as "pure guesses", that given for the main plant being $300,000. (Stip. ¶3 and Exs. 11-K and 12-L.) On the following December 1 the underwriters' representative executed an endorsement to the outstanding cover notes amending the latter so as to provide that "Effective inception the amount at Main Plant, Marshall is reduced to $4,000 per diem"; a copy of the endorsement was by the agents sent to the accountants with a letter dated January 11, 1966. (Stip. ¶3, Exs. 13-M and 15-O; Tr. A, p. 20; Tr. B, pp. 15-16.)

Formal policies evidencing the contract of insurance provided for in the cover notes were executed by the insurers under date of January 21, 1966, and were delivered by the agents to the accountants on August 24, 1966. Included in each policy was a so-called schedule seting out the amount of coverage with respect to each plant. The schedule provided with respect to the main plant that the amount payable for each working day of total suspension of business was $4,000, that the limit as to "each and every loss" was 180 days, and that from each adjusted claim the sum of $5,000 would be deducted. The policies also included the following provisions:

INSURING CLAUSE

TOTAL SUSPENSION: The conditions of this contract of insurance are that if the said buildings and/or structures and/or machinery and/or equipment and/or raw stock or stock in process contained therein shall be

destroyed or damaged by Fire, Lightning, Explosion, Aircraft, Vehicles, Windstorm, Strikers, Riot(er)s, or Smoke, as hereinafter defined, occurring during the term of the Policy so as to necessitate a total suspension of business then this insurance shall be liable at a rate of $ As schedule per working day for such total suspension.

PARTIAL SUSPENSION: If the property damage due to perils insured against results in partial suspension of business then this insurance shall be liable for such proportion of $ As Schedule per working day which the proportion of reduction in output bears to the total production which would, but for such partial suspension, have been obtained during the period of partial suspension.

CONDITIONS

It is a condition of this contract that the length of time of suspension for which loss may be claimed for either total or partial suspension as defined under the Insuring Clause above shall not exceed as per schedule working days and shall commence at the date of damage to the property insured hereunder but loss shall not be claimed for days on which the operations of the Assured are not normally performed. The length of time for which suspension may be claimed shall not be limited by the date of expiration of this contract.

* * *

No claims shall be sustained against this Policy unless and until the Insurers of the Direct Damage to the property covered shall have paid a loss or admitted liability in respect of the occurrence giving rise to the claim made against this Policy.

* * *

(Stip. ¶4, Exs. 16-P, 17-Q; Deft's Exs. 25, 26, 27.)

The taxpayer's main plant was on February 17, 1966, damaged by a fire which necessitated a total suspension and, following such total suspension, a partial suspension of the business carried on therein. The taxpayer submitted proofs of loss under the foregoing use and occupancy policies under date of October 5, 1966, and on the basis thereof the insurers in November and December 1966 and January 1967 paid $506,530.73, of which $168,000 accrued during the taxable year ended March 31, 1966, and $338,530.73 accrued during the taxable year ended March 31, 1967, in consideration of which the taxpayer on January 4, 1967, delivered a release. (Stip. ¶5, Exs. 18-R, 19-S.) In determining the portion of the foregoing total which was payable by reason of partial suspension of business, the only facts taken into consideration were the comparative number of units of production before and after the fire, not comparative net profit figures. (Tr. B, pp. 11-12, 18-19.)

The main plant was again damaged by fire, this time on September 21, 1966. The fire resulted in a total suspension of business, and under the foregoing policies the taxpayer by reason thereof was on June 10, 1967, paid the further sum of $620,000, all of which accrued during the taxable year ended March 31, 1967. (Stip. ¶7, Exs. 23-W, 24-X.)

In addition to the foregoing payments under the use and occupancy policies, the plaintiff received payments under the policies providing for reimbursement for the direct physical damage to the plant caused by the two fires. (Tr. B, p. 24.)

In its returns for fiscal 1966 and 1967 the petitioner reported the foregoing accruals as long-term capital gains.

Deficiencies were determined thereafter, of which $300,596.36 was attributable to taxing such accruals as ordinary income. This amount together with $93,074.32 interest thereon was paid, followed by the filing on June 2, 1972, of claims for refund and the bringing of this action. (Stip. ¶8.)

REASONS FOR GRANTING THE WRIT

ONE. The decision of the Court of Appeals is in conflict with that of the Court of Appeals for the Sixth Circuit in *Shakertown Corp.* v. *Commissioner* (1960), 277 F.2d 625, to which no reference is made in the opinion of either the District Court or the Court ofAppeals.

It is believed that this conflict exists notwithstanding that the statute in issue in *Shakertown* was §112(f) (1) of the Internal Revenue Code of 1939, the identical predecessor of §1033(a) (1) of the 1954 Code, not, as in the present case, §1231(a) of the 1954 Code. The conflict exists because the condition precedent to possible applicability of §1231(a) is precisely the same as the condition precedent to possible applicability of §1033(a) (1). Just as in the latter that condition is that "property" must "as a result of its destruction in whole or in part" be "compulsorily or involuntarily converted", so in §1231 (a) it is that there must be a "compulsory or involuntary conversion (as a result of destruction in whole or in part * * *) of property". Quite plainly, a transaction which falls within the foregoing words of either of these statutes falls also within those of the other. So far as presently material, the statutes differ only in the consequences they present with respect to any gain resulting from the conversion. Where-

as under §1033(a), the gain is not taxed if the converted property, no matter what its kind, is converted into "property similar or related in service or use", under §1231(a), if the converted property is, as here, "property used in the trade or business" or is "capital assets held for more than 6 months", the gain is taxed, but only as capital gain.

In view of the foregoing it must be said that the decision of the Court of Appeals in this case is in conflict with that of the Court of Appeals in *Shakertown*. Indeed, in holding in that case that proceeds of policies of valued use and occupancy insurance were the product of an involuntary conversion the Court went far beyond where it is necessary to go to reach the same result in this case. For in that case, while the policy provided for the payment of fixed daily amounts, it provided further, contrary to what is true in this case, that the insured submit periodic reports of net profits and that, in the event of failure to do so, the amounts payable under the policy would be reduced to the assured's "actual net profits" during the twelve months preceding occurrence of the loss. Notwithstanding the foregoing, the Court concluded (p. 629) that there was a statutory involuntary conversion because under the insuring clauses there was "no insurance of lost profits"; it said (p. 629) that there was "a lack of correlation between loss of profits and recovery under the policies" and that the provision referred to above was "for the purpose of limiting the liability of the insurer, instead of creating any liability."[3]

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[3]Subsequent to the filing of the complaint in this case and thirteen years after the *Shakertown* decision the Internal Revenue Service issued Rev. Rul. 73-477, 1973-2 C.B. 302, wherein it announced it "does not

It appears that in only one previous case has the taxable status of use and occupancy insurance policy proceeds been directly at issue under §1231. That case is *Maryland Shipbuilding and Drydock Co.* v. *United States* (Ct. Cl., 1969), 409 F.2d 1363. We believe that the decision at bar is in direct conflict also with this decision. We do so notwithstanding that it was held therein that the proceeds of fixed daily indemnity policies of use and occupany insurance received by reason of stoppage of business operations because of accident were taxable as ordinary income, not as capital gain under §1231. We are of this view because, as quoted by the Court (pp. 1364-1365), the policies provided expressly that the amount payable thereunder "is agreed by the Underwriters and the Assured as correctly representing the Loss of Earnings * * * which the Assured would sustain" by reason of such stoppage, and because, in the words of the Court (p. 1365)—

> No reason is offered and none is apparent, for rejecting the parties' explicit contractual understanding as to the nature and purpose of the daily indemnity monies.

The Court then went on to point out (p. 1365) that factually the case before it was not like *Shakertown* and other cited lower court decisions, in that the holdings in those cases "were expressly predicated on the fact that,

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follow the decision of the United States Court of Appeals for the Sixth Circuit" in that case. The ruling makes clear that the announcement is based on the premise that the quoted limitation established that the insurance contract was "designed to reimburse the taxpayer for a loss of net profits and fixed charges." Whether or not this conclusion is sound is presently immaterial, for there is nothing in the insurance contracts presently in issue which insures against lost net profits, and, moreover, no net-profit figures were ever supplied.

unlike the coverage here involved, the policies provided for a flat daily indemnity payment basically unrelated in amount to profits or the loss thereof", which is precisely what must be said of the policies in issue in the present case.

TWO. The decision of the Court of Appeals is contrary to past administrative practice which, under the holdings of this Court, must be deemed to have received Congressional approval.

The first income-tax legislation relating to "involuntary conversions" of property was contained in §214(a) (12) and 234(a) (14) of the Revenue Act of 1921(c. 136, 42 Stat. 227), both of which provided that their provisions should "apply so far as may be applicable to * * * gains from gross income under prior income tax acts." It appears that the first litigated case involving application of these provisions to the proceeds of valued use and occupancy insurance received by reason of destruction of property is *International Boiler Works Co.* (1926), 3 B.T.A. 283. The taxpayer there contended (p. 290) that the amount received under the policies was exempt under §234(a)(14) because it represented "the proceeds of an involuntary conversion of property expended in replacement". The Board of Tax Appeals held to the contrary because (p.290), as in *Maryland Shipbuilding*, "[t]he insurance is expressly stated in the policy to be against the loss of profits on business prevented." Less than two months later the Board dealt with the same issue again under the same statute in *Piedmont-Mt. Airy Guano Co.* (1926), 3 B.T.A. 1009. In this instance, however, the Board concluded that the policy proceeds expended in replacement of the destroyed property were exempt from

tax because the policy provided, as do those presently in issue, for the payment of a stated amount for each working day of enforced suspension of use and occupany, which right, the Board held (pp. 1014-1015), was an "integral part of the property destroyed", with the consequence that the policy proceeds "were proceeds from the involuntary conversion of the property as contemplated by §234(a)(14)". *International Boiler Works Co.* was distinguished on the ground (p.1015) that "[t]he language of the policy there involved left no doubt as to subject matter by stating that, in the event the property was destroyed or damaged by fire, the company should be liable for the 'actual loss sustained of net profits on the business, which is thereby prevented,' whereas the policy now before us contains no such provisions".

Later in the same year, 1926, the Board in *Flaxlinum Insulating Co.*, 5 B.T.A. 676, all sixteen members concurring, came to the same conclusion reached in *Piedmont* on basically similar facts, and it did so notwithstanding that, contrary to what is true in the present case, one of the policies in issue contained a provision requiring (p. 683) that the taxpayer, as soon as possible after destruction of its plant, secure use of other property and that in that case the fixed daily amount otherwise payable should be reduced by "the net profits earned at the new location". Again *International Boiler Works* was distinguished, and for the same reason. (P. 688.)

Within less than a year after their rendition, the Commissioner of Internal Revenue published an announcement that he "acquiesces in" both the *Piedmont* and *Flaxlinum* decisions, with the explanation that "decisions so acquiesced in should be relied upon by officers

and employees of the Bureau of Internal Revenue as precedents in the disposition of other cases before the Bureau." Internal Revenue Cumulative Bulletins V-2, pp. (iv) and 3, and VI-1, pp. (iv) and 2. Five years later, however, in 1931, Cumulative Bulletin X-1 carried the Commissioner's announcement revoking his acquiescence in *Piedmont* and *Flaxlinum* and reporting his non-acquiescence therein, for what reason is not stated. (Pp. 1, 73, 79, 89.) It appears that thereafter no case involving an issue similar to the foregoing issue in *Piedmont* and *Flaxlinum* came before the courts until in *Williams Furniture Corp.* (1941), 45 B.T.A. 928, wherein again it was held, upon authority of *Piedmont* and *Flaxlinum* (pp. 936, 937), that fixed daily amounts of insurance paid by reason of loss of use and occupancy of property caused by its destruction represented the proceeds of involuntary conversion and therefore, since they were used to replace the destroyed property, were exempt from tax under §112(f) of the Revenue Acts of 1934 and 1936, the predecessor of §1033(a) (1).

Williams was decided December 9, 1941. Before the end of the following June the Commissioner of Internal Revenue announced his acquiescence not only in the *Williams* decision but also in the *Piedmont* and *Flaxlinum* decisions, simultaneously announcing the withdrawal of his 1931 interim non-acquiescences in these latter decisions. Cum. Bull. 1942-1, pp. 1, 6, 13, 17. These acquiescences have now continued in effect uninterruptedly for a third of a century and represent the Treasury's published agreement that payments made under policy terms and in factual circumstances basically similar to those present in the instant case are not a

substitute for lost net profits but represent rather the proceeds of involuntary conversion for purposes of §1033 (a)(1).

On July 14, 1942, immediately following announcement of the Commissioner's acquiescence in the foregoing three decisions the Ways and Means Committee of the House of Representatives filed its H. Rep. No. 2333 (77th Cong., 2d Sess.) wherein it recommended amendment of the 1939 Code by adding thereto §117(j)—now §1231 of the 1954 Code—and amendment of the existing §112(f) (1)—now §1033(a) (1). The first amendment provided for extension of the involuntary conversion provisions of §112(f) to depreciable property used in trade or business, which is excluded from the definition of capital assets. See Code §1221(2). The committee explained (1942-2 Cum. Bull., pp. 372, 445) that—

> [g]ain or loss on the sale, exchange, or involuntary conversion of property used in the trade or business of a character subject to the allowance for depreciation * * * is treated under existing law as ordinary gain or loss * * * . Section 117(j) as added by section 137(b) of the [Revenue] bill [of 1942] provides special treatment for * * * the gains and losses upon the compulsory or involuntary conversion of such depreciable property * * *.
>
> The method prescribed is to treat such gains and losses * * * as gains and losses from the sale or exchange of capital assets * * * if the aggregate of such gains exceeds the aggregate of such losses. If, however, the aggregate of such gains does not exceed the aggregate of such losses, such gains and losses shall not be treated as gains and losses from the sale or exchange of capital assets * * * .

Immediately following this recommendation was a cognate recommendation for the amendment of §112(f) of the 1939 Code, now §1033(a) (1) of the 1954 Code. This recommendation was as follows (Ibid., p. 446):

> Section 112(f) of existing law provides that upon the involuntary conversion of property into property similar or related in service or use to the property so converted, or into money which is forthwith spent in the acquisition of such property, neither gain nor loss is recognized. It is believed more equitable to recognize the loss in such cases. Accordingly, section 137(c) of the bill amends section 112(f) to provide that loss shall be recognized upon an involuntary conversion.

Similar recommendations and explanatory statements were made by the Senate Committee on Finance. (Ibid., pp. 504, 594, 595.) See also the report of the Committee of Conference. (Ibid., pp. 701, 708-709 re amendments Nos. 149-151, 154, 158.) The recommended amendments were embodied in the Rev. Act of 1942, 56 Stat. 838, 844-847.

It is now 33 years since application of the "involuntary conversion" concept contained in §112(f) of the 1939 Code, now §1033(a) of the 1954 Code, was extended by enactment of §117(j) of the 1939 Code, now §1231 of the 1954 Code, so as to apply to the conversion of business property, not only into property "similar or related in service or use to the property so converted," as required by §112(f), but also into money. During the whole of this period the Commissioner has continued publication of his announced agreement with and the precedential status of the foregoing cited decisions holding that payments received under policies and in circumstances not basically

different from those in the instant case represent the proceeds of involuntary conversion. Since 1953, moreover, the income-tax regulations which he has promulgated have stated unqualifiedly that—

> The proceeds of a use and occupancy insurance contract which *by its terms* insured against actual loss sustained of net profits in the business, are not proceeds of an involuntary conversion but are income in the same manner that the profits for which they are submitted would have been. (Italics added.)

Regulations 118, §39.112(f)-1(c)(8), and Title 26, Code of Federal Regulations, §1.1033(a)-2(c)(8). Furthermore, during all these years Congress has repeatedly re-enacted the statutory provisions relating to involuntary conversions without changing in any way the statements made therein of what constitutes such a conversion.[4]

In circumstances such as these, as this Court has declared several times, the Commissioner's practice as evidenced by his acquiescence in the *Piedmont, Flaxlinum,* and *Williams* decisions and by his regulations must be deemed to conform to the will of Congress. As said in *Fribourg Navigation Co.* v. *Commissioner* (1966), 383 U.S. 272, 283, "the Commissioner's prior long-standing

[4]During the period since 1942 the provisions of §§112(f) and 117(g) of the 1939 Code and their successors, §§1033(a)(1) and 1231(a) of the 1954 Code, have been the subject of simultaneous amendments not less than three times. As §§112(f) and 117(j) of the 1939 Code, they were amended by the Revenue Act of 1951, the former by §318(b)(1) thereof and the latter by §§322(c)(3) and 323(a). Public Law 82-183. As §§1033(a) and 1231(a) of the 1954 Code, they have been amended simultaneously at least twice. The first time was in the Technical Amendments Act of 1958, Public Law 85-866, §45 of which amended §1033(a) and §49(a) of which amended §1231(a). The second time was in the Tax Reform Act of 1966, Public Law 91-172, §915(a) of which amended §1033(a), and §516(a) of which amended §1231(a).

and consistent administrative practice must be deemed to have received Congressional approval" where, as here, Congress has "repeatedly re-enacted * * * without significant change" the statutory provisions under which the "administrative and judicial precedent was accumulating". See also *Boehm* v. *Commissioner* (1945), 326 U.S. 287, 291-292.

THREE. It is the petitioner's view that its position is given support in the opinion of this Court in *Commissioner* v. *Gillette Motor Co.* (1960), 364 U.S. 130, in which it was held that compensation for the mere temporary taking by the Government of possession of business facilities is not within §117(j) of the 1939 Code, now §1231 of the 1954 Code.

In coming to this conclusion the Court noted (p. 134) that the enactment of 117(j) in 1942 accomplished only two main objectives. The first was the extension of capital gains treatment to real and depreciable personal property used in trade or business, which is excluded from the definition of capital assets contained in §1221 of the 1954 Code, and the second was to accord such treatment to involuntary conversions both of capital assets as strictly defined and of property used in trade or business . In view of the foregoing the Court concluded (pp. 134-135) that , though the mere right to use property is itself a "valuable property right", it is nevertheless neither a capital asset within §117(a)(1) of the 1939 Code (§1221 of the 1954 Code) nor property used in the trade or business, with the consequence that there was no involuntary conversion within §117(j). However, in so concluding the Court made it plain that if the loss of use of the facilities had been caused by their damage, §117(j) would have been applicable. It said(p. 135):

> Had the Government * * * damaged them physically beyond the ordinary wear and tear incident to normal use, the resulting compensation would no doubt have been treated as gain from the involuntary conversion of capital assets.

Since there was such damage in the present case, and since the resulting compensation was paid by reason thereof and was neither measured by nor an agreed substitute for lost net profits, there was an involuntary conversion within §1231.

Respectfully submitted,

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APPENDIX

STATUTES

Title 26,U.S.Code (Internal Revenue Code)
Sec. 11. TAX IMPOSED

(a) CORPORATIONS IN GENERAL.—A tax is hereby imposed for each taxable year on the taxable income of every corporation. * * *

SEC. 1201 ALTERNATIVE TAX.

(a) CORPORATIONS.—If for any taxable year a corporation has a net section 1201 gain, then, in lieu of the tax imposed by sections 11, 511, 821(a) or (c), and 831(a), there is hereby imposed a tax (if such tax is less than the tax imposed by such sections) which shall consist of the sum of a tax computed on the taxable income reduced by the amount of the net section 1201 gain, at the rates and in the manner as if this subsection had not been enacted, plus—

(1) in the case of a taxable year beginning before January 1, 1975—

(A) a tax of 25 percent of * * *

(ii) the amount of the net section 1201 gain

* * *

SEC. 1221. CAPITAL ASSET DEFINED.

For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not

connected with his trade or business), but does not include—

* * *

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business * * *

SEC. 1222. OTHER TERMS RELATING TO CAPITAL GAINS AND LOSSES.

(3) LONG-TERM CAPITAL GAIN.—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income.

* * *

(7) NET LONG-TERM CAPITAL GAIN.—The term "net long-term capital gain" means the excess of long-term capital gains for the taxable year over the long-term capital losses for such year.

* * *

(11) NET SECTION 1201 GAIN.—The term "net section 1201 gain" means the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year.

SEC. 1231. PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS.

(a) GENERAL RULE.—If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary con-

version (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation of the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. * * *

* * *

(b) DEFINITION OF PROPERTY USED IN THE TRADE OR BUSINESS.—For purposes of this section—

(1) GENERAL RULE.—The term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not—

(A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year,

(B) property held by the taxpayer primarily for sale customers in the ordinary course of his trade or business

* * *

The following statutory provision is added because its application (or that of identical predecessors) is involved in several decisions cited in the petition for the writ:

SEC. 1033. INVOLUNTARY CONVERSIONS.

(a) GENERAL RULE.—If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted—

(1) CONVERSION INTO SIMILAR PROPERTY. Into property similar or related in service or use to the property so converted, no gain shall be recognized.

(2) CONVERSION INTO MONEY WHERE DISPOSITION OCCURRED PRIOR TO 1951.— * * * For purposes of this paragraph and paragraph (3), the term "disposition of the converted property" means the destruction, theft, seizure, requisition, or condemnation of the converted property, or the sale or exchange of such property under threat or imminence of requisition or condemnation. * * *

(3) CONVERSION INTO MONEY WHERE DISPOSITION OCCURRED AFTER 1950.—Into money or into property not similar or related in service or use to the converted property, and the disposition of the converted property (as defined in paragraph (2)) occurred after December 31, 1950, the gain (if any) shall be recognized except to the extent hereinafter provided in this paragraph:

(A) NONRECOGNITION OF GAIN.—If the taxpayer during the period specified in subparagraph (B), for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted, or purchases stock

in the acquisition of control of a corporation owning such other property, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion (regardless of whether such amount is received in one or more taxable years) exceeds the cost of such other property or such stock

* * *

UNITED STATES DISTRICT COURT
DISTRICT OF MINNESOTA
SECOND DIVISION

MARSHALL FOODS INC.,

Plaintiff,

vs.

UNITED STATES OF AMERICA,

Defendant.

ORDER

2-72 Civ. 334

Hayner N. Larson, Erwin M. Goldstein, 1300 Northwestern Bank Building, Minneapolis, MN 55402, attorneys for plaintiff

Robert G. Renner, United States Attorney, by Stephen Palmer, Assistant United States Attorney, attorneys for defendent.

This income tax refund case, submitted to the Court on stipulated facts and briefs, requires the determination of whether certain proceeds of insurance policies paid to the

plaintiff should be taxed as ordinary income or as capital gains. The plaintiff, during its tax years 1966 and 1967, was engaged in the manufacture and sale of powdered eggs. For this purpose, plaintiff operated an egg drying plant, its main plant, and a feed plant known as the Kelco plant. The insurance policies in question provided benefits to the plaintiff if and when his business was interrupted by certain hazards, incuding fire. In the event of a total interruption of business, the policy provided for a daily payment of $4,000 and in the envent of a partial interruption, the benefits would be proportional to the amount of output curtailed. There was to be a $5,000 deductable on any benefits paid.

On February 17, 1966 and again on September 21, 1966, plaintiff's main plant was damaged by fire. As a result, payments under these insurance policies amounting to a total of over $1.1 million were made to plaintiff. Of this amount, $168,000 accrued during the taxable year ending March 31, 1966, and the balance accrued in the following year.

In filing its return for these years, plaintiff treated the amounts accrued as capital gains. Subsequently, deficiencies in tax were determined for both years. The portion of the deficiencies attributable to the income at issue amounted to $79,414.82 in the 1966 tax year, and $221,181.54 in the 1967 tax year. The deficiencies were noted because, in the IRS's view, the amounts paid to the plaintiff by reason of the total and partial suspension of business should have been taxed as ordinary income, rather than as long-term capital gain.

The deficiencies and accrued interest were paid and plaintiff filed claims for the deficiency and interest so paid.

More than six months have passed since the filing of the claims for refund and no response has been made by the defendant. This Court, therefore, has jurisdiction to hear the matter pursuant to 28 U.S.C. §1346(a)(1).

The parties agreed to submit the case on stipulated facts and briefs, and have done so to such an extent that there is but one issue remaining for determination. Plaintiff contends that the legal issue of whether the payments were a substitute for lost income, or compensation for the loss of use of the assets should be resolved in favor of compensation. Defendants argue that it should be resolved as a substitute for income and, alternatively, that it doesn't make any differeence how the Court resolves it since, in either case, the insurance payments should be treated as ordinary income as opposed to long-term capital gains.

This Court is of the opinion that the issue should be resolved in favor of the defendant, in favor of the proposition that the payments in question were a substitute for lost income and should therefore be taxed as ordinary income.

It is a fundamental principle of tax law that the taxable status to the recipient of daily indemnity monies is identical to that of the monies that they are intended to replace. *Maryland Shipbuilding and Drydock Co.* v. *United States*, 409 F.2d 1363, 1365 (Ct. Cl. 1969); *Miller* v. *Hocking Glass Co.*, 80 F.2d 436 (6th Cir. 1935), *cert. denied* 398 U.S. 659 (1936).

The case of *Commissioner* v. *Gillette Motor Co.*, 364 U.S. 130 (1959), sets out the general principles on the characterization of income that results from an involun-

tary conversion of capital assets that consist of real or depreciable personal property used in a trade or business. In that case, the Court noted that there are two valuable property rights that can be compensated for after an involuntary conversion: the investment in the physical assets themselves and the right to determine the use to which the physical assets are to be put. The former property right when converted is taxed as a §1231 capital gain, while the latter when converted is 61(a) ordinary income. *Id.* at 135-6.

The plaintiff in his memorandum concedes this point and agrees that the proceeds from a "business interruption" policy or a "use and occupancy" policy can and do give rise to ordinary income liability when it in fact compensates for loss of profits, rents, earnings, etc. *Citing Massillon-Cleveland-Akron Sign Co.*, 15 T.C. 79 (1950); *Williams Furniture Corporation*, 45 B.T.A. 928 (1941); *Flaxlinum Insulating Co.*, 5 B.T.A. 678 (1926); and *Piedmont-Mt. Airy Guano Co.*, 3 B.T.A. 1009 (1926).

The particular facts in this case lead this Court to the conclusion that insurance benefits received by plaintiff were to compensate him for the loss of earnings and profits.

(1) The stipulated facts reflect that in addition to the insurance policies now under discussion, plaintiff had contracts of insurance providing for payment of the amount of monetary loss sustained by reason of direct damage to the physical properties of the plaintiff's plants. Therefore, the use and occupancy insurance indemnity could not be for the loss of investment in the physical assets themselves.

(2) The insuring clause notes that the condition precedent to coverage is not just destruction or damage but destruction or damaged "so as to necessitate a total (or partial) suspension of business." Therefore, the situation could arise wherein there could be total suspension with destruction of a $1.00 piece of equipment that would call for the total *per diem* benefit or wherein there could be destruction of an expensive piece of equipment with no suspension of operation which would not necessitate the payment of any *per diem* benefit. It is clear that suspension of business, not destruction of the asset, is the triggering event. (*See (1) supra.*)

(3) In the deposition of Stanley Carlson, an individual who was involved in the procurement of the insurance in question, the issue of the *per diem* coverage on the Paynesville plant was raised. The Paynesville plant supplied material to the Marshall plant. It was noted that if there was a decrease in the volume of business at the Marshall plant due to a hazard covered by the policy, fire for example, that caused a decrease in the volume of the Paynesville plant, the policy in question was to be extended to cover the actual loss sustained at the Paynesville location. The only loss that could be meant there is loss of earnings from the failure to have a market for 20% of their production that had to go to the Marshall plant. *See*, Defendant Deposition Exhibit 25.

(4) The correspondence between the plaintiff and the insurance agency that was attempting to place the business interruption insurance in question reflects the need for justification for the amount of indemnity requested.

In response to that inquiry the plaintiff forwarded information based totally on gross earnings. The insurance was written on that information alone. The business interruption worksheet is of particular interest. From that it is obvious that what is being compensated for is the loss of part of the "profits"[1] of the business. The *per diem* figure of $4,000 was arrived at by assuming future annual gross earnings of $1,500,000 minus estimated annual payroll costs of $300,000 divided by 300 annual working days.

(5) In the depostion of Charles S. Benson, one of plaintiff's representatives in the securing of the insurance policies which are the subject of this litigation, it becomes apparent that with respect to the business interruption worksheet that was requested by the insurer, the actual loss sustained figures were to be equated with the loss of net profits (Benson depo. at 4). He admitted that the indemnity was dependent on gross earnings divided by number of work days. Later on in the deposition, Mr. Benson admitted that, with respect to partial suspension of operation, the indemnity was to be based on actual dollars of production divided by base period dollars of production times four thousand dollars ($4,000).

The previously enumerated facts point out how the insurance indemnity payments cannot represent a reimbursement for the loss of the property itself and seem to be calculated on lost earnings. Defendant's argument that these indemnity insurance payments should be taxed as capital gains therefore must be on the theory that they

[1]Profit here is used in the largest sense as the gain made by the sale of produce or manufactures, after deducting the value of the largest single expense item— labor.

represent payments to offset costs that are incurred when the plant is not in operation.

If the payments do represent payment for costs, they still do not qualify for capital gains treatment. The special tax treatment provided by Subchapter P applies only to gain or loss realized on the sale or exchange[2] of capital assets as defined in §1221, and to gain or loss which, under special statutory provisions, is "considered as" gain or loss from the sale of capital assets.

There is no capital asset involved here. In the normal course of business, the earnings of the corporation would be diminished by the payment of not only employees' salaries but also rent, depreciation, advertising, etc. Here the insurance indemnity will take the place of those earnings, to be a source for these payments, to provide the corporation with its "profit." They are the same as accounts or notes receivable that are specifically excluded from the definition of a capital asset §1221(4).

The Supreme Court has suggested that the preferential treatment of capital gains tax is intended not only to relieve the tax payer of the excessive tax burden on gains resulting from what may well be appreciation over a number of years in capital investments, but also to permit economic mobility. The Court has also concluded that since the section is an exception to the normal tax requirements of the Internal Revenue Code, the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly. *Corn Prod. Refining Co. v.*

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[2]Since there is no capital asset involved in this case the Court need not decide whether the involuntary conversion in this case fits within the statutory definition of "sale or exchange." Nor does the Court need to rule on the question of the statutory holding period.

Commissioners, 350 U.S. 46 (1955). Giving "earnings" capital gains treatment not only negates legislative intend [sic] for Subchapter P but also undermines the legislative intent for §61.

For these reasons, the proceeds from the insurance policies in question should have been taxed as ordinary income under §61(a). Therefore the deficiencies assessed were correct and plaintiff's claim for the deficiency and interest is denied.

IT IS SO ORDERED.

Dated: Dec. 2, 1974

MILES W. LORD
United States District Judge

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 75-1018

MARSHALL FOODS, INC.,

Appellant,

vs.

UNITED STATES OF AMERICA,

Appellee.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF MINNESOTA

Submitted: May 14, 1975

Filed: June 2, 1975

Before LAY, WEBSTER and HENLEY, Circuit Judges.

PER CURIAM.

In this appeal, the appellant-taxpayer contends that in the circumstances of this case the district court[1] erred in holding that proceeds received by taxpayer from a business interruption insurance policy are taxable as ordinary

[1]The Honorable Miles W. Lord, United States District Judge for the District of Minnesota.

income. We reject appellant's contentions and affirm the judgment of dismissal on the basis of the district judge's well reasoned and comprehensive opinion. See Rule 14.

A true copy.
Attest:

CLERK, U.S. COURT OF APPEALS, EIGHTH CIRCUIT.

In the Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-286

MARSHALL FOODS, INC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

The sole issue presented by the petition is whether amounts petitioner received under a business interruption insurance policy are taxable as ordinary income, as the decision below held, and not as capital gains from the involuntary conversion of property used in its trade or business.

The pertinent facts are as follows: During 1966, petitioner had business interruption insurance policies in effect covering its egg-drying plant. The policies provided for the payment of a stated amount for a maximum period of 180 days in the event of a total or partial suspension of business as a result of the de-

594-004—75——1

struction or damage to the plant by fire or other specified perils. Petitioner also maintained insurance covering damage to its physical property. The stated per diem payment for the business interruption insurance was derived by taking an average gross income figure based upon the average production from the insured plant and reducing that amount by various expenses that would not be incurred during an interruption in operations, such as ordinary payroll. The resulting amount was then divided by the number of working days in a year (Pet. App. A–6).

Petitioner's plant was damaged by two fires in February and September, 1966, which resulted in suspension of production. Pursuant to the business interruption policy, petitioner received $506,530.73 and $620,000, respectively. Petitioner accrued these amounts as long-term capital gain in its taxable years ending March 31, 1966, and March 31, 1967. On audit, the Commissioner determined that these amounts were taxable as ordinary income. In this refund suit, the district court upheld the Commissioner's position (Pet. App. A–5 to A–12), and the court of appeals affirmed *per curiam* (Pet. App. A–13 to A–14).

Section 61(a) of the Internal Revenue Code of 1954, 26 U.S.C., defines gross income as "all income from whatever source derived." As this Court has repeatedly stated, Congress has imposed no limitations as to the source of taxable receipts and no restrictive labels as to their nature. See, *e.g., Commissioner* v. *Glenshaw Glass Co.,* 348 U.S. 426, 429–430. It is well settled that the tax characterization of amounts received as compensation for a loss is identical to that of the amounts

they are intended to replace. *Hort* v. *Commissioner,* 313 U.S. 28. Thus, the lower federal courts have uniformly held that insurance proceeds received as compensation for the loss of profits resulting from the partial or total suspension of a business are taxable as ordinary income. *Shakertown Corp.* v. *Commissioner,* 277 F. 2d 625 (C.A. 6); *Massillon-Cleveland-Akron Sign Co.* v. *Commisioner,* 15 T.C. 79; *Miller* v. *Hocking Glass Co.,* 80 F. 2d 436 (C.A. 6), certiorari denied, 298 U.S. 659.

Here, the conclusion of the district court that the payments in question were a substitute for the income petitioner lost as a result of its business interruptions is well supported by the evidence. Under the policy, the daily indemnity payments reflected the anticipated daily gross earnings that petitioner would lose as a result of a suspension in its production minus the cost of goods sold and other production costs that would not be incurred during the suspension. The indemnity payments thereby provided petitioner with an amount equal to anticipated gross earnings. The earnings themselves would have been taxable ordinary income; the insurance proceeds, which were designed to take the place of those earnings, are also taxable as ordinary income.

Petitioner contends (Pet. 10–11) that the payments in question represent proceeds from the involuntary conversion of "property" which is taxable as long-term capital gain under Section 1231 of the Internal Revenue Code of 1954. In petitioner's view, the "property" is the right to use its plant. However, peti-